WRMarketplace

An AALU Washington Report

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TOPIC: ERISA Fundamentals – A Primer on Fiduciary Duties.

MARKET TREND: Most employers offer employee benefit plans to their employees as a part of a competitive compensation package. Employers sponsoring these plans, particularly retirement plans, need to understand that ERISA may subject them to a higher standard of conduct with respect to plan administration.

SYNOPSIS: To protect employees with regard to certain employer-sponsored benefits, ERISA imposes fiduciary responsibilities on employers and others plan manager and administrators, which can be enforced by lawsuits and civil penalties from the Department of Labor. Anyone that has discretionary authority with respect to the administration of a plan or the disposition of its assets is considered a fiduciary under ERISA and must meet certain duties in the discharge of its obligations under the plan. Paramount among these duties are the duty of loyalty, which requires a plan fiduciary to act solely in the interests of the plan participants and beneficiaries, and the duty of prudence, which requires the fiduciary to act with a high level of conscientiousness when carrying out its role with respect to the plan. Compliance with these and other duties can impact the plan investments and the transactions that persons classified as fiduciaries can enter into on behalf of a plan.

TAKE AWAYS: People who carry out functions with respect to employee benefit plans must confirm whether they are fiduciaries with respect to those plans. If so, care should be taken to familiarize themselves with the duties and standards of conduct to which they will be held in that capacity to avoid potential exposure to litigation and penalties. Often, the advice of experienced professionals, such as legal counsel, investment consultants and insurance advisers, is advisable to help them review and meet their fiduciary duties.

ERISA was enacted with a principal purpose of providing protection for employees with respect to employer-sponsored benefits, particularly retirement benefits. To support its purpose, ERISA creates a fiduciary relationship between certain parties and employee benefit plans and establishes a set of fiduciary standards with which these parties must comply. As failures in compliance can result in lawsuits and civil penalties, employers, plan sponsors, and their advisors should have a basic awareness of the required fiduciary duties to help recognize when fiduciary status exists and when compliance is mandated.

WHO IS A FIDUCIARY?

Under ERISA, a person is a fiduciary to the extent he or she exercises the following authorities or takes the following actions:

1. Exercises any discretionary authority or control respecting management of the plan or management or disposition of the plan's assets,
2. Has any discretionary authority or responsibility in the administration of the plan, or
3. Renders investment advice for a fee or other compensation, direct or indirect, with respect to plan assets, or has any authority or responsibility to do so (note: the subject of who is a fiduciary by virtue of rendering investment advice for a fee is a hot topic now due to the issuance of new DOL rules in this area. See extensive coverage of this issue in AALU's special series "*Deciphering the DOL Rule - Implementation Essentials*").

Common fiduciaries are plan trustees, sponsors (though they often delegate discretionary authority for plan management to a fiduciary committee), administrators, and investment consultants. Mere record-keepers and third-party administrators that do not have discretionary authority to make decisions concerning plan operations generally are **not** fiduciaries.

WHY DOES FIDUCIARY STATUS MATTER?

Classification as a fiduciary under ERISA means the imposition of several duties, as described below. Compliance with these duties will also prevent the fiduciary from engaging in certain "prohibited transactions." Failure to comply can cause exposure to lawsuits from plan participants or the Department of Labor ("DOL") and the imposition of civil penalties by the DOL (e.g., up to a 20% penalty on the amount involved in the fiduciary breach).

WHAT ARE THE DUTIES OF A FIDUCIARY?

An ERISA fiduciary must discharge its obligations to a plan subject to certain specific duties:

- A duty of ***loyalty***;
- A duty of ***prudence***;
- A duty ***to diversify plan investments***;
- A duty ***to follow plan documents***; and
- A duty ***to avoid prohibited transactions***.

Duty of Loyalty. The duty of loyalty requires the fiduciary to discharge his or her duties ***solely in the interests of the participants and beneficiaries*** and for the ***exclusive purpose*** of providing benefits to participants and their beneficiaries, and defraying reasonable expenses of administering the plan. Violations occur when a fiduciary places its self-interest or the interest of the plan sponsor or other third party ahead of the interests of the plan or its participants.

Duty of Prudence. This duty requires a fiduciary to act ***with the care, skill, prudence, and diligence under the circumstances as a prudent man acting in a like capacity would act.***

Fulfilling ERISA's duty of prudence requires compliance with a two-pronged test: (1) a procedural test that looks at the methods and criteria used by a fiduciary in reaching a decision, requiring the fiduciary to conduct a diligent investigation before making the decision, including a thorough, independent analysis of any expert advice, and (2) a substantive test, that looks at the actual results of the fiduciary's decisions. For example, in making investment decisions, this test would look at not only the investment performance of the plan assets, but also the criteria and expertise the fiduciary used in making the investment decision and selection.

Note that ERISA's prudent man standard is ***not*** based on the ordinary reasonable man standard but ***requires varying degrees of expertise*** from fiduciaries depending on the nature and needs of the plan. Thus, ***if plan fiduciaries do not have the expertise necessary to evaluate a decision with respect to the plan, they should seek out and base their decision on expert advice.***

Duty to Diversify Plan Assets. A fiduciary has a duty to diversify the investments of the plan, unless clearly prudent not to do so. Examples of situations where courts have commonly found a breach of the duty to diversify include when (1) a large percentage of plan assets have been placed in a single investment or (2) virtually all of a plan's assets have been placed in investments that violated other provisions of ERISA (such as making loans to the plan sponsor).

Duty to Follow Plan Terms. A fiduciary has a duty to operate the plan, substantively and procedurally, according to the terms of the plan documents, to the extent they are ERISA-compliant. For example, from a substantive standpoint, a fiduciary may not use plan assets to purchase employer securities if the plan prohibits investments in such assets. Procedurally, a fiduciary breach would occur if a plan fiduciary independently entered into a contract on behalf of the plan if the plan documents require contract approval by two fiduciaries.

Duty Not to Engage in Prohibited Transactions. ERISA prohibits a fiduciary from causing a plan to engage in a broad range of direct and indirect transactions with certain interested parties unless an exemption applies, and requires a fiduciary to avoid "self-dealing. A fiduciary has the duty not to cause the plan to engage, ***directly or indirectly***, in these transactions.

WHAT ARE PROHIBITED TRANSACTIONS

Generally. Prohibited transactions include transactions with a "party in interest" and acts of self-dealing. A "party-in-interest" includes not only plan fiduciaries, but also other parties having an interest in the plan, such as employers, plan sponsors (and the sponsor's affiliates), and service providers. As noted in the chart below, however, certain statutory and administrative exemptions may allow the plan to engage in otherwise prohibited transactions.

Overview of Prohibited Transactions	
Party-in-Interest ("PII") Transactions	Self-Dealing
• ***NO sales, exchanges or leases of any property between the plan and a PII.*** E.g., no sales of securities or real property held by a plan to a sponsoring employer. • ***NO loans or extensions of credit between the plan and a PII.*** Includes indirect loans - i.e., a fiduciary cannot make a loan to an independent party if it knows that party will loan the proceeds to a PII. *Note:* most plan loans to 401(k) participants or beneficiaries can qualify for an exemption. • ***NO furnishing of goods, services, or facilities between the plan and a PII.*** E.g., an affiliate of an employer or a fiduciary cannot provide services for a fee to the plan without meeting an exemption. • ***NO transfers to, or use by or for the benefit of, a PII, of any plan assets.*** Plan assets should not be commingled with assets of an employer or of any other employee benefit plan. • ***NO acquisition on behalf of the plan of any employer securities or real property.*** Allowed only if all conditions of the statutory exemptions are met.	• ***NO dealing with the assets of the plan in the fiduciary's own interest or for its own account.*** Prohibits self-dealing, including the use of plan assets to make payments to the fiduciary, to pay personal expenses of the fiduciary, or to make investments that personally benefit the fiduciary. • ***NO acting in any transaction involving the plan on behalf of a party with adverse interests***. A fiduciary may not represent the plan in a transaction in which the fiduciary has an interest that may be adverse to the plan. Transactions in which plan assets are used to benefit the plan sponsor or an affiliate (rather than the fiduciary itself) also may violate this provision. • ***NO consideration paid to the fiduciary's personal account from any party in a transaction involving plan assets***. Prohibits "kickbacks" – i.e., situations in which a fiduciary receives consideration from a third-party as an incentive to do business with the plan.

WHAT ABOUT PLAN INVESTMENTS?

Perhaps the biggest concern of plan fiduciaries relates to the investment performance of plan assets. When ERISA was first enacted, most retirement plans were either defined benefit plans or defined contribution plans, under which the plan fiduciaries managed the investment of participants' accounts. Now, the majority of retirement plans are 401(k) plans, in which participants are responsible for directing the investment of their accounts.

Under ERISA § 404(c), generally a plan fiduciary will not be liable for losses resulting from the participant's direction of the investment of plan assets if the participant is able: (1) to exercise control over his or her account, (2) to choose from a sufficiently broad and diverse set of investment alternatives, and (3) to receive adequate information about the investment alternatives available under the plan so that the participant can exercise independent control over his or her investment decisions.

A plan fiduciary can still be held liable for plan losses, however, if it is demonstrated that it was not prudent to offer a losing investment alternative under a plan. Accordingly, the appropriate plan fiduciary must monitor the performance of the investment alternatives offered under the plan. In addition, a great deal of focus has been paid recently on the fees charged by plan investments and plan service providers. The plan fiduciary must ensure that these fees are reasonable and that the fees, as well as the performance of the investment alternative, are disclosed periodically to plan participants. Failure to provide these disclosures will cause the fiduciary to lose the protection of ERISA Section 404(c).

TAKE AWAYS

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